United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-6161

ORIGINAL

United States Court of Appeals

FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

—against—

GALAXY FOODS, INC., ARTHUR LIEBERMAN a/k/a ARTY LEE, RALPH AVNI, CHARLES HOROWITZ, BRUCE KATZ, STEVEN ROTH, MARK GLAZER, IRWIN DONALD KIRSCHENBLATT a/k/a DONALD KIRSCH, GEORGE PADILLA, ARTHUR SHEVACK,

Defendants,

IRWIN DONALD KIRSCHENBLATT a/k/a DONALD KIRSCH and ARTHUR SHEVACK,

Defendants-Appellants.

REPLY BRIEF

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Defendants-Appellants.

REPLY BRIEF

Introductory Statement

This brief is submitted by defendants-appellants in reply to the answering brief submitted by plaintiff-appellee.

POINT I

The District Court lacked jurisdiction over the subject matter of this litigation.

We respectfully submit that in responding to appellants' brief, the Securities and Exchange Commission has begged the most crucial issue before this Court, to wit, whether the Federal Court has jurisdiction over the subject matter of this litigation. In so doing, the Securities and Exchange Commission has endeavored to ignore the clear and unambiguous language contained in *SEC* v. *W.J. Howey Corp.*, 328 U.S. 293, 301 (1946), where the Supreme Court stated that an investment contract involves "an investment of money in a common enterprise with profits to come *solely* from the efforts of others". (Emphasis supplied).

Significantly, in defining what an investment contract is, the Supreme Court had before it the statute, (and the legislative history related thereto) as amended, upon which the Securities and Exchange Commission now relies for the purpose of imposing jurisdiction.

Recognizing that the Supreme Court well knew the "flexible" rather than the "static" principle desired to be furthered by the Congress of the United States at the time of the passage of the legislation and at the time of the passage of the amendments thereto, we must all the more suppose that in defining an investment contract as it did, the Supreme Court did not intend to bring within the purview of the statutes those investments from which one does not exclusively or solely rely upon the efforts of others in his attempt to realize profits.

The term "solely" has been construed to mean that which "leaves no leeway". *Helvering* v. *Southwest Consol. Corp.*, 315 U.S. 194, 198.

Similarly, this Court has construed the word solely as that which means "exclusively and leaves no leeway". *Stockton Harbor Industries Co.* v. *C.I.R.*, 216 F.2d 638, 645.

This Court has also interpreted the word solely to mean "'exclusively' and the 'only one'". *U.S. ex rel. Wulf* v. *Esperdy*, (CA2, 1968) 227 F.2d 537, 538.

The meaning of the word "solely" is clear and precise; it does not mean substantially; it does not mean significant; it means exactly as this Court and the Supreme Court have construed that word. It means only.

In their zeal to correct apparent wrongdoing involving the sale of franchises, both the Fifth and the Ninth Circuit Courts of Appeal have endeavored to extend the definition of the word "solely" as utilized by the United States Supreme Court, in *Howey*, supra, to include situations where, in the opinion of those Courts, franchisees, while not relying solely upon the efforts of others, were relying substantially or significantly upon the efforts of others.

We submit, however, that save for a zealous desire to correct an apparent wrong, there was no justification for either Circuit Court to construe the *Howey* language other than as the Supreme Court had already defined same. Indeed, remedial relief must, in light of the Supreme Court's pronouncement, depend upon an act of the Congress of the United States. In the interim, it is for the legislators of each State to correct that which it believes to be detrimental to the well-being of its citizenry.

We do not here speak as the apologists for the commission of wrongdoing; rather, we question the propriety of extending the jurisdictional limitations imposed upon the Federal Courts both by the Congress of the United States and the Supreme Court of the United States.

Most recently, the United States Supreme Court once again reaffirmed the language of the *Howey*, supra, decision holding that if a "purchaser is motivated by a desire to use or consume the item purchased", the Federal Securities Laws do not apply. *United Housing Foundation* v. *Forman*, 421 U.S. 837, 95 S. Ct. 2051 (1975).

In the case at bar, and as previously noted in appellants' main brief, each of the franchisees who had purchased a franchise from Galaxy Foods intended to engage in an independent business operation; each intended to sell and market food at retail to the general public; each knew that he could not earn any monies save through his own personal efforts in retailing the food, in hiring and maintaining a sales force, in advertising and in the creation of his own customer lists. None understood that, having made his investment, he could sit back and gain rewards merely through the ownership of a franchise. Each understood that the corporation could lose money on its operation, though he, the franchisee, could realize profit from his own sales; each understood the reverse to also be true. In brief, no one believed that he held any form of equity interest in Galaxy Foods, Inc.

If wrong has in fact been committed, the remedy lies not with the Federal Courts but with state and local authorities.

POINT II

Scienter was required to be proven by the Securities and Exchange Commission before it was entitled to the relief granted by the lower Court.

In *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375 (1976), a civil damage proceeding commenced by a private litigant, the Supreme Court, held that plaintiff had to plead and prove scienter before liability could be imposed.

The S.E.C., in relying upon *SEC* v. *Universal Major Industries Corp.*, CCH Fed. Sec. L. Rep. ¶95, 804 (CA2, December 16, 1976) argues that scienter need not necessarily be proven before the imposition of liability and that it may, instead, demonstrate the existence of negligent conduct in order to establish liability.

Obviously, the Commission fails to distinguish between a private litigant's action for monetary damages and an S.E.C. enforcement proceeding wherein an injunction is sought arising out of the non-registration of an acknowledged security, as in *Universal Major Industries*, supra. The instant action is, in essence, a private litigant's case wherein the S.E.C. sought to recover monetary damages for the franchisees who had invested in franchises issued by Galaxy Foods. The S.E.C. stood in the shoes of a private litigant; and, to that end, the requirements of proving scienter are the same as they were in *Ernst & Ernst* v. *Hochfelder*, supra. Lest there by any doubt as to those individuals in whose behalf the S.E.C. initiated the proceeding, one need only examine the plaintiff's complaint wherein the S.E.C. specifically announced that it sought disgorgement for and on behalf of the "investors". (p. 20a).

The law does not intend that the Commission should be accorded a lesser need for the submission of proof in a disgorgement proceeding than would be required of a private litigant. See Bromberg, *Securities Law: Fraud*, §10.2(2) (1975).

CONCLUSION

Accordingly, and for the foregoing reasons, the judgment of the District Court should be, in all respects, reversed and judgment for defendants-appellants should be directed and entered.

Respectfully submitted,

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